TEACHERS' RETIREMENT BOARD

SUBCOMMITTEE ON CORPORATE GOVERNANCE

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Securities class action litigation has existed for many years, and CalSTRS has participated in such litigation both as a passive class member and, in one instance, as a co-lead plaintiff (Cal Micro Devices). More recently, much attention has been focused on the role of institutional investors such as CalSTRS in such litigation as a result of the Private Securities Litigation Reform Act of 1995 (PSLRA), which was enacted over President Clinton's veto in late 1995.

Specifically, a number of the stakeholders in this area (the Securities and Exchange Commission (SEC), academics, corporate governance activists, and, more recently, members of the plaintiffs' attorneys' bar that has litigated these cases in the past have urged institutional investors, and public pension funds in particular, to seek so-called "lead plaintiff" status in securities class action litigation. The purpose of today's panel is to provide the Corporate Governance Subcommittee with a range of views of the advantages and disadvantages of this course of action as well as to discuss the mechanics involved and possible alternatives to this approach. The following information is provided to the Subcommittee by way of brief introduction to the subject area.

A. Nature and Causes of Securities Class Action Litigation

Securities class action litigation as a term of art essentially refers to litigation involving securities fraud or some other form of corporate malfeasance that is brought as a class action. A "class action" is a case that is brought by an individual, group of individuals or entity on behalf of all others who have suffered the same type of loss. In a class action, everyone is in the "class," i.e., those who suffered harm are covered for all purposes of the litigation by the results of such litigation unless a class member "opts out." A class member that opts out chooses not to participate in the class action and instead elects either to file a separate case in the member's own name or not to engage in any litigation.

Securities class action litigation may be filed in either state or federal court, although this discussion will be limited to such actions that are filed in federal court since that has been the focus of institutional investor involvement. The litigation is brought in the shareholders' names against the offending corporation, and sometimes as well against individual officers thereof and/or other parties that may have played a role in the alleged wrongdoing (such as accounting firms). As such, this type of litigation may be distinguished from shareholder derivative actions, in which shareholders sue individual officers and/or employees of the corporation and/or involved third parties *on behalf of* the corporation. In other words, a securities class action is a lawsuit by shareholders seeking reimbursement *from* the corporation and related parties for their losses, while derivative cases seek reimbursement from individuals or entities *to* the corporation.

Most frequently, securities class action litigation is triggered by the following elements: 1) a major move in the price of a security (usually, but not always downward), and 2) either insider trading by corporate insiders and/or accounting irregularities. Roughly 50 or 60 percent of such cases involve allegations of insider trading and approximately 60% involve allegations of accounting irregularities. Some complaints allege both of the latter elements; only 10% allege neither.

In securities class action litigation, the court appoints a lead plaintiff. The lead plaintiff is, in effect, the representative of the class and has the responsibility to supervise plaintiffs' counsel in the conduct of the litigation. This includes the formulation of litigation strategy and, most significantly, the negotiation of any settlement of the litigation. If a proposed settlement is reached, the agreement is subject to a review by all class members, who may advise the court of any objections to its contents. The court is given the final say with respect to acceptance or rejection of the agreement after considering arguments both pro and con from the class.

B. Pre-PSLRA Criticisms of Securities Class Action Litigation

In the years prior to the enactment of the PSLRA, securities class action litigation came under increasing scrutiny for several reasons. First, identification of a lead plaintiff was largely a function of which plaintiffs' attorney was able to "win the race to the courthouse" and be the first to get a lawsuit on file. Second, the lead plaintiff was generally an individual shareholder "found" by the attorney, who often had a relatively small number of shares in the defendant corporation and therefore may not have been the best representative of the class at large. Third, defendant corporations claimed that many of the cases were "strike suits," i.e., cases with little or no merit filed in an effort to obtain a nuisance value settlement. Fourth, shareholder advocates contended that meritorious cases were being settled for inadequate consideration, either or both in terms of monetary value and nonmonetary remedies (such as corporate governance reforms). Fifth, the percentage of case recoveries going to plaintiffs' attorneys (typically 30%) was criticized as being too high related to both the time expended by counsel and the value received by shareholders.

C. Enactment of the PSLRA

The PSLRA made a number of significant changes in the way in which securities class action cases are handled in federal court. It requires parties that wish to serve as lead plaintiff to file an application with the court, which then must select "the most adequate plaintiff as lead plaintiff." There is a presumption that the person or group with the largest financial interest in the relief sought by the class is the most adequate plaintiff, unless that person or group is subject to unique defenses or otherwise cannot be expected to fairly and adequately represent the class. It should be noted that the largest financial interest is not determined by the entity with the largest absolute loss in the security, but rather by the largest monetary loss resulting from a drop in securities purchased during the class period in which the wrongdoing took place. For example, assume that XYZ corporation sustained a 50% percent drop in the price of its common stock and two stockholders, A and B, are competing for selection as lead plaintiff. If A owned $2 million in shares prior to the drop, but purchased only $250,000 of the shares during the class period, it would have less of a financial interest in the litigation than B, which owned $1 million of the shares prior to the drop, all of which were purchased during the class period. Although A's total losses are more than B's, its financial interest in the litigation is $125,000, which is less than B's financial interest of $500,000.

Although this provision was designed to favor the appointment of institutional investors as lead plaintiffs, the results to date have been far from definitive. Perhaps not surprisingly, the court procedures concerning lead plaintiff appointment have often become very contentious. Where institutional investors have sought lead plaintiff status, they have often found themselves in competition with large aggregations of individual shareholders, combinations of individual and institutional investors, and other stand-alone institutional investors. Often, the lead plaintiff application of an institutional investor is challenged on the grounds that their interests are dissimilar from those of the individual investors. For example, institutional investors are portrayed as "buy and hold" investors with different interests in the outcome of the litigation than "buy and sell" individual investors.

The judicial response to this situation has been mixed. In some instances, institutional investors have been appointed as sole lead plaintiff. In others, an aggregation of individual plaintiffs have been appointed as "co-lead plaintiff" with an institutional investor or a group of institutional investors. Such arrangements pose obvious issues of command and control of the litigation. This is still an evolving area under the PSLRA.

Once a court has selected a lead plaintiff or co-lead plaintiffs, the lead plaintiff(s) may then select class counsel. The selection of class counsel is subject to court approval. As such, counsel representing the lead plaintiff during its application for lead plaintiff status may end up not representing the class in the actual litigation. This is not a merely theoretical result. Some courts have been very active in their review and approval of class counsel, to the point of ordering that firms wishing to serve as class counsel participate in an "auction" process where an otherwise qualified firm that submits the lowest fee bid wins the right to represent the class; sometimes, but not always, with the lead plaintiff's firm of choice being given the opportunity to match the low bid.

D. <u>Possible Rationales for Public Pension Funds to Seek Lead Plaintiff Status in Securities Class Action Litigation</u>

As noted previously, there has been an increasing call for institutional investors generally, and public pension funds specifically, to affirmatively seek out lead plaintiff status in securities class action litigation. Those who support this call have contended that active public pension fund participation in this litigation could bring about the following salutary benefits:

- Increased settlement recoveries;
- Reduced attorneys' fees;
- A higher level of accountability for corporate wrongdoing, by either holding corporate officers personally liable and/or by enacting corporate governance reforms designed to prevent a repeat of the problems (appointment of outside directors, independent audit committees, etc.).

In addition, there is a view that increased institutional involvement as lead plaintiffs could discourage the filing of frivolous lawsuits by refocusing contingent fee agreement practices to provide very low fee percentages in so-called "nuisance value" cases and/or by taking control of such suits when demonstrated to be nonmeritorious and seeking an early resolution thereof.

In essence, the suggested role for public pension funds in securities class action litigation represents an effort to put the interests of class members ahead of those of class counsel and to increase the deterrent effect of such litigation. By this means, it is hoped that such actions would provide a higher level of compensatory value to those who actually were harmed by corporate wrongdoing, and that greater integrity in the underlying financial markets generally would result.

In a recent court filing, the Secretary of the U.S. Department of Labor has suggested that ERISA fiduciaries have an affirmative duty to determine whether it would be in the interest of plan participants to seek to serve as a lead plaintiff in securities class action litigation. Finally, there is a view in the public pension fund field that with some public pension funds already getting involved, others need to "take their turn at bat."

With respect to the "case specific" economics, the following statistics are provided for the Subcommittee's information. The most-frequently cited figure for the average settlement in a securities class action case is approximately $10 million. The range of actual recoveries is very wide, although few cases have settled for in excess of $100 million. These settlements recover, on average, approximately 10-14% of the total actionable loss sustained by shareholders. These settlements are almost always fully covered by proceeds from the defendant corporations' insurance proceeds. Plaintiffs' attorneys typically receive approximately 30% of the settlement proceeds as their fee, although there appears to be a recent trend of a lowered percentage in the larger cases. There are approximately 500 securities class action cases currently pending in federal court.

CalSTRS, as a passive class member in securities class action litigation, has received a total of $7,961,742 in proceeds from some 400 cases since January 1986 to the present. The average proceeds on a per-case basis were $19,904, and the median amount received was $5887. The range in proceeds was from a low of $1.00 to a high of $877,455. Six-figure amounts have been received in 13 cases to date.

As reflected by the above statistics, the difficulty with CalSTRS pursuing lead plaintiff status for case-specific economic reasons is that in most instances the incremental increase to a class action settlement that may result, while large in absolute dollar terms, will be relatively small in terms of CalSTRS' share thereof. Unlike some public pension funds that have taken a very active role in this area, such as the State of Wisconsin Investment Board (SWIB), which is actively managed and has taken relatively large stakes (10-20%) in the stock of specific companies, CalSTRS is largely indexed and rarely owns more than 1% of the outstanding shares of a publicly traded corporation. As a result, even if CalSTRS was able to become lead plaintiff in a case that would otherwise have settled for $50 million but, through CalSTRS' proactive management of the litigation settled instead for $100 million, if CalSTRS had a 1% share of the recoverable losses the net gain to the System over passively participating in the case would only be $500,000.

As a result, there are likely very few cases where CalSTRS should consider seeking lead plaintiff status purely to maximize its economic recovery in the litigation. Staff believes that the Board's fiduciary obligations in this regard would be fulfilled if, on a case-by-case basis, any cases in which CalSTRS had a significant financial interest (in terms of both purchases during the class period and absolute dollar amount) were brought to the Investment Committee for consideration of seeking lead plaintiff status.

In addition, it should be noted that public pension funds such as CalSTRS could exert significant influence on the outcome of such litigation in some instances in the absence of seeking lead plaintiff status. For example, CalSTRS could advise the court of its support of a public pension fund's application for lead plaintiff status where appropriate. Also, some funds are engaging in active monitoring of litigation involving a significant fund holding, with the prospect of formally intervening in such litigation in the event that its interests are not adequately being represented. Another alternative is actively opposing an inadequate settlement and urging more appropriate terms at the time the matter is before the judge for approval.

The issue of pursuing lead plaintiff status in appropriate cases for the purpose of bringing about greater accountability for corporate wrongdoing is deserving of careful consideration by the Subcommittee. Allegations of insider trading and accounting irregularities and litigation arising from such allegations have existed for years, and if anything have been on the increase recently. Plainly, the manner in which shareholder class action litigation has been conducted over the same period of years has done little to deter such wrongdoing. It is not difficult to understand why this is so, in that with insurance proceeds covering most settlements and with individual corporate wrongdoers rarely facing personal financial liability, there is generally no accountability for wrongdoing in the litigation process.

One option of several for attempting to bring more accountability for corporate wrongdoing would be for public pension funds such as CalSTRS to seek lead plaintiff status and attempt to seek a resolution of the case, by settlement or otherwise, that would include such factors as personal liability in some amount for those involved in the unlawful activity and/or corporate governance reforms such as the appointment of an independent audit committee and/or outside directors. Such action could serve to both get at the real problems in the corporation that allowed the unlawful activity to take place in the first place as well as to create some measure of deterrent effect more generally in the market. This strategy would be complementary with the System's current corporate governance activities, which are geared to increasing shareholder value both in individual "targeted" corporations as well as in the markets at large.

Pursuit of lead plaintiff status for these reasons could potentially place the public pension fund at odds with other class members that are more interested in simply maximizing their financial recovery from their failed investment. This is likely not an insurmountable problem, however, since these objectives are not necessarily inconsistent with maximizing the financial aspects of a given settlement.

There are some options that have been discussed in this area that could be pursued either in concert with or as an alternative to seeking lead plaintiff status for "governance/deterrence" purposes. These include: 1) Working with the SEC to enhance their civil and criminal enforcement capabilities in this area; 2) Working with appropriate offices of the United States Attorney to seek criminal prosecutions of corporate officers in particularly egregious instances of fraud, such as what occurred in the Cal Micro Devices case; and 3) working with the insurance companies that underwrite corporate errors and omissions policies on "best practices" procedures that could be followed by a corporation in exchange for reduced insurance premiums.

E. Introduction of Panel

To discuss the issues raised above, and to address any other related matters of concern to Subcommittee members, the following four panelists will make brief presentations and then be available as a group to answer any questions.

Sarah Teslik is the Executive Director of the Council for Institutional Investors. Founded in 1985, the Council is an organization of over 100 public, corporate and Taft-Hartley pension funds that seeks to address investment issues affecting the size and security of its members $1.3 trillion in assets. Prior to the formation of the Council, Ms. Teslik was a corporate and securities attorney with Willkie Farr & Gallagher in Washington, D.C. Ms. Teslik has a B.A. in History from Whitman College, Walla Walla Washington, an M.A. in Modern History from Oxford University, and a J.D. from Georgetown University Law Center in Washington, D.C.

George Kim Johnson is the General Counsel for the Public Employees' Retirement Association of Colorado, with assets of $28 billion. Prior to joining ColPERA, he was General Counsel for the Louisiana State Employees' Retirement System. Kim is past president of the National Association of Public Pension Attorneys, serves on the Executive Committee of the Council for Institutional Investors, is a member of the Board of Governors of the International Corporate Governance Network, and represents ColPERA on the Advisory Board of the Global Corporate Governance Research Center. He received is B.A. in Government and his J.D. from Louisiana State University.

Jean S. Moore is a partner with Hogan and Hartson in Washington, D.C. and is a member of the firm's litigation practice, emphasizing corporate financial and securities fraud litigation. She has represented both plaintiffs and defendants in federal and state securities litigation, and along with Joe Hasset and George Mernick is currently lead plaintiffs' counsel for CalSTRS and ColPERA in the California Micro Devices case. Prior to joining Hogan and Hartson, she was with with the White House Office of Special Counsel. She received her B.A. and J.D. degrees from Ohio State University.

Ian Lanoff is a principal at Groom Law Group in Washington, D.C. and is a member of the firm's employee benefits practice. In addition to serving as CalSTRS' fiduciary counsel, he is outside fiduciary counsel for the Texas Teachers Fund and the Florida Public Employees Pension Fund, and advises corporate pension plan clients sponsored by A T & T, U.S. West, Microsoft, Sears, Delphi, and Agway. He additionally represents a number of multiemployer Taft-Hartley pension plans. Prior to entering private practice, Mr. Lanoff was the Administrator of Pension and Welfare Benefit Programs at the U.S. Department of Labor. He received his B.A. and J.D. degrees from the University of Michigan and his L.L.M. from Georgetown University Law School.